Three ways to help improve participants' retirement outcomes in a lower-return world

Implications from our 2017 Long-Term Capital Market Assumptions

AUTHORS

Anne Lester
Portfolio Manager and Head of Retirement Solutions

Daniel Oldroyd, CFA, CAIA
Portfolio Manager and Head of Target Date Strategies

Christie Wootton, CFA
Client Portfolio Manager

Individuals already struggling to achieve a financially secure retirement face an intensifying challenge. Not only are they living longer, they are also confronted with declining expectations for long-term returns on their retirement assets. Ultimately, retirement saving and investing decisions are in the hands of employees. We believe, however, that the most effective venue in which to address the retirement challenge is the workplace—where employee and employer objectives, payroll and benefit systems, communication, education and incentive programs come together. Granted, neither plan sponsors nor their advisors/consultants can control the markets, but there are concrete actions they can take to improve the likelihood that participants will reach retirement with the assets they need.

J.P.Morgan
Asset Management

OUR LONG-TERM MARKET VIEW

The overriding message from our 2017 Long-Term Capital Market Assumptions (LTCMAs) is clear: Expectations for market returns over the next 10 to 15 years have declined for most asset classes—while volatility forecasts are marginally higher. The combination of lower fixed income returns, a decline in economic growth assumptions and reduced equity returns pulls the efficient frontier uniformly down (**EXHIBIT 1**).

In an overall portfolio context, the return for a simple 60% world equity/40% U.S. aggregate bond portfolio (in our view, a reasonable proxy for the average asset allocation over a typical participant's life span) is expected to be in the neighborhood of 5.5% to 6.0%, roughly 75 basis points below our 2016 assumptions. In fact, the major components of this 60/40 portfolio are among the asset classes with the proportionately greatest decline in return assumptions vs. last year's estimates.

WHEN THE GOING GETS TOUGH, THE TOUGH GET ACTIVE

Plan sponsors face a stark choice once they have acknowledged the outlook for lower returns. They can stay the course—with participants contributing at their current deferral rates, often into relatively undiversified portfolios. Alternatively, they can take action to help improve retirement outcomes: encourage participants to save more; consider investment strategy options that can make portfolio diversification easier; and provide participants with the opportunity to enhance returns through the use of active management.

1 Encourage greater savings

Participants need to save more and start early. We've said it many times, and it still bears repeating. The downgrading of our long-term economic growth and market return assumptions, combined with longer life expectancy, points to a heightened possibility of participants outliving their retirement savings. Saving more is the most obvious and effective way to improve retirement outcomes.

We believe the best approach to encouraging saving is to actively place participants on a solid savings path through plan design options such as automatic enrollment and automatic contribution escalation. Many plan sponsors are concerned that participants might push back on any attempt to diminish their control over the contribution decision. Our research suggests, however, that most participants are in favor of, or at least neutral toward, these programs.[1]

2 Make portfolio diversification easier

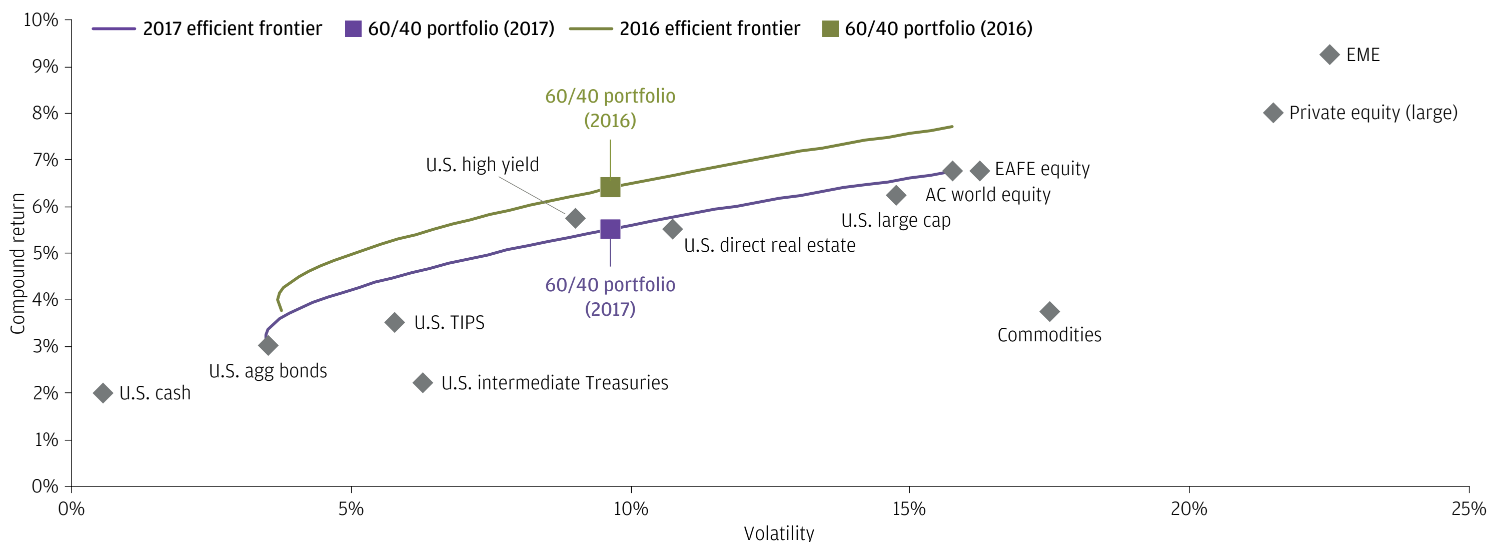
One way for a participant invested in a simple 60/40 portfolio to enhance expected returns is to shift assets from fixed income to equity, moving to the right along the efficient frontier depicted in Exhibit 1—but this implies taking on additional market risk.

Diversification can help. Expanding the investment opportunity set to include, for example, high yield debt and a greater allocation to emerging market equity can help enhance expected return, while

[1] J.P. Morgan Plan Participant Research 2016.

Our long-term return expectations have declined vs. a year ago

EXHIBIT 1: EFFICIENT FRONTIERS AND 60/40 PORTFOLIOS* BASED ON 2017 VS. 2016 LTCMAS FOR RISK AND RETURN



Source: J.P. Morgan Asset Management; estimates as of September 30, 2015, and September 30, 2016.

*Allocation for 60/40 portfolios: 60% Morgan Stanley Capital International All Country World Index (MSCI ACWI) and 40% Bloomberg Barclays US Aggregate Bond Index.

adding real estate, with its relatively low correlation to both equity and debt, can help dampen volatility. The addition of such assets can help shift the efficient frontier up and to the left. What's more, compared with the major components of a simple 60/40 portfolio, LTCMA 2017 return estimates for these asset classes have held up relatively well vs. last year's estimates. The goal, of course, is not simply to offer a broader range of asset classes within the core menu, which would leave the complex task of asset allocation to plan participants. In fact, our research suggests that only about one-third of participants are confident in their ability to choose the right investment options from their plan lineups. A similarly small percentage are confident that they can appropriately adjust the allocation of their portfolios as they approach retirement.[2]

We believe the best way for participants to access a diversified palette of investment options is through professionally managed portfolio strategies, such as target date funds. When the glide paths underlying these strategies are based on a consistently derived set of long-term asset class return, risk and correlation assumptions, combined with strategic asset allocation expertise and awareness of participants' behavior and changing investment needs over the life cycle, these strategies can guide the allocation of assets over time. In short, target date funds can help participants realize the true advantages of diversification all along the road to retirement.

3 Employ active management

It's important to keep in mind that there are two components of return: the portion due to the market itself (beta) and the portion resulting from active manager skill (alpha). Our Long-Term Capital Market Assumptions, by design, do not reflect returns to active management; they are estimates of index-based (or beta) returns, intended to inform strategic allocation or policy-level decisions over a 10- to 15-year investment horizon.

With a lower return outlook for most asset classes, and an uncertain period of U.S. presidential transition and potentially greater market volatility ahead, investors will need to embrace a broader opportunity set. This means not only investing in more asset classes but also having the opportunity to generate alpha. This can be achieved both through skilled managers—professional investors adept at security selection—and through tactical asset allocation: the ability to opportunistically shift assets across sectors, asset classes and regions as attractive opportunities present themselves. And given the low correlation between the alpha and beta components of return, the active component can also help to diversify portfolio risk.

[2] J.P. Morgan Plan Participant Research 2016.

IMPLICATIONS FOR PLAN SPONSORS AND THEIR ADVISORS/CONSULTANTS

More than ever, a secure retirement requires saving adequately and investing wisely. We encourage plan sponsors who have not already done so to work with their plan advisors/consultants and evaluate the feasibility of the following actions for their plans:

- Adopt automatic enrollment and automatic contribution escalation to encourage greater saving.
- Consider target date funds as the plan's qualified default investment alternative to help ensure that participant portfolios are broadly and effectively diversified—both initially and as participants approach retirement.
- Select professionally managed target date fund strategies with the potential to provide enhanced returns through both skilled security selection and tactical asset allocation.

It's true—the outlook for long-term capital market returns has been downgraded. But automatic plan design options through which participant assets are, by default, invested in actively managed target date funds can help plan sponsors place and keep more participants on the road to a secure retirement.

Opinions and estimates offered constitute our judgment, are not specific to any particular plan and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. This document is a general communication being provided for informational purposes only; is educational in nature and not designed to be a recommendation for any specific investment product, strategy, plan feature or other purpose. Any examples used are generic, hypothetical and for illustration only. Prior to making any investment or financial decisions, you should seek individualized advice from your personal financial, legal, tax and other professional advisors that take into account all of the particular facts and circumstances of your own situation.

Long-Term Capital Market Assumptions: Given the complex risk-reward trade-offs involved, we advise clients to rely on judgment as well as quantitative optimization approaches in setting strategic allocations. Please note that all information shown is based on qualitative analysis. Exclusive reliance on the above is not advised. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance. References to future returns for either asset allocation strategies or asset classes are not promises of actual returns a client portfolio may achieve. Because of the inherent limitations of all models, potential investors should not rely exclusively on the model when making a decision. A manager's ability to achieve similar outcomes is subject to risk factors over which the manager may have no or limited control.

JPMorgan Distribution Services, Inc., member FINRA / SIPC.

J.P. Morgan Asset Management is the marketing name for the asset management businesses of JPMorgan Chase & Co. and its affiliates worldwide.

Copyright © 2017 JPMorgan Chase & Co. All rights reserved.

RI-LTCMADC | 0903c02a81c04129

J.P.Morgan
Asset Management